

COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

USGEN NEW ENGLAND, INC.)
NEW ENGLAND POWER COMPANY)
MASSACHUSETTS ELECTRIC COMPANY)
NANTUCKET ELECTRIC COMPANY)

Docket D.T.E. 97-94

REBUTTAL TESTIMONY

OF

PAUL F. LEVY

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USGen New England, Inc.
New England Power Company
Massachusetts Electric Company
Nantucket Electric Company
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Witness: Levy

1 INTRODUCTION

2 Q. Please state your name and business address.

3 A. My name is Paul F. Levy. My business address is 77 Massachusetts Avenue, Cambridge,
4 MA.

5 Q. By whom are you employed and in what capacity?

6 A. I am Adjunct Professor of Environmental Policy at the Massachusetts Institute of
7 Technology. I am also an independent consultant offering strategic planning and advice;
8 litigation and regulatory support; negotiation training and assistance; and arbitration for
9 domestic and international firms and government in the water, wastewater, energy, and
10 telecommunications fields.

11 Q. Have you testified before in this proceeding?

12 A. Yes. My direct testimony was included in the October 1, 1997 filing in this proceeding.
13 As I explained in that testimony, I acted as an advisor to the NEES Companies on the
14 conduct of the divestiture, and believe that the sale is strongly procompetitive. The
15 proposed sale separates non-nuclear generation, including purchased power commitments,
16 from NEP's transmission and Mass. Electric's distribution business and, as described by

1 Dr. Pace in his testimony, represents a significant step in disaggregating the New England
2 electric utility industry.

3 PURPOSE OF TESTIMONY

4 Q. What is the purpose of your testimony?

5 A. My testimony responds to certain arguments made in the testimony of Richard L. Levitan,
6 submitted on behalf of Enron Capital and Trade Resources. Mr. Levitan asserts that the
7 divestiture of New England Power Company's ("NEP's") non-nuclear generating business
8 in accordance with an agreement between NEP and other subsidiaries of the New England
9 Electric System ("the NEES Companies") and USGen New England, Inc. ("USGenNE")
10 fails to mitigate adequately NEP's burdens under power purchase contracts and
11 undermines consumer interests. As I will explain, Mr. Levitan's argument fails to
12 recognize that the bidding process that the NEES Companies utilized in seeking offers for
13 NEP's non-nuclear generating assets was carefully structured to maximize the mitigation
14 of costs that otherwise would be stranded by the introduction of competition, to be borne
15 by the customers of the NEES retail distribution companies, including Massachusetts
16 Electric Company and Nantucket Electric Company (together "Mass. Electric"). The
17 NEES Companies' decision to take an integrated approach to the mitigation of these
18 costs, rather than the piecemeal approach that Mr. Levitan favors, was a reasonable way

1 to mitigate the total contract termination charges that otherwise would be payable by
2 Mass. Electric.

3 Mr. Levitan also asserts that the requirement of the winning bidder to enter into an
4 iron-clad obligation to serve load under Mass Electric's standard offer rate depresses the
5 asset value. As I will explain, this assertion cannot be proven but, even if it were the case,
6 Mr. Levitan's complaint has no validity because it ignores the context and public policy
7 aspects of the auction process within the entire electricity restructuring effort that is taking
8 place in Massachusetts. The standard offer commitment is an essential part of that effort,
9 and the NEES companies appropriately took that into account in designing the auction.

10 THE NEES COMPANIES' APPROACH TO MITIGATION

11 Q. Mr. Levitan claims that the NEES Companies commitments under power purchase
12 agreements with non-utility generators ("NUGs") "have been left unmitigated." Do you
13 agree?

14 A. No. Mr. Levitan's claim presumes that the only way that costs associated with NUG
15 contracts can be mitigated is through separate negotiation with individual NUGs. While,
16 as Mr. Hachey explains, NEP has successfully reduced its exposure to above-market
17 purchased power costs, Mr. Levitan's basic assumption is wrong. NEP decided to
18 structure the bidding process for its non-nuclear generating business in a manner that was

1 designed to bring competitive forces to bear on mitigation opportunities, including
2 opportunities to mitigate the costs of NUG purchase commitments. Mr. Levitan is simply
3 wrong in claiming that this process harmed the interests of consumers. To the contrary,
4 consumers benefit because bidders for NEP's generation were induced by the process that
5 the NEES Companies utilized to reflect aggressive assumptions regarding opportunities
6 for NUG contract mitigation in their bids. Bidders, rather than consumers, assumed the
7 risks of actually realizing those mitigation assumptions.

8 Q. Please explain the bidding process that the NEES Companies employed.

9 A. In consultation with professional advisors, including Merrill Lynch, a leading investment
10 banker, the NEES Companies decided to employ a two-step bidding process. In the first
11 stage, the NEES Companies solicited indications of interest from companies around the
12 globe that might be interested in entering or expanding the electric generating business
13 through acquiring all or a portion of NEP's non-nuclear generating assets. Prospective
14 bidders were given an information memorandum and provided opportunities to learn
15 additional information about NEP's generating businesses. They were asked to submit
16 non-binding proposals for all or a portion of NEP's generating business, based on certain
17 simplifying assumptions. Twenty-five companies submitted proposals in March 1997.
18 The goal, from the perspective of the NEES Companies, was to gauge the level of interest

1 in NEP's non-nuclear generating assets and to use the information from the non-binding
2 proposals to structure a final round of bidding in a manner that would maximize the
3 amount received, which would be applied to mitigate the contract termination charges
4 paid by Mass. Electric and ultimately by its customers.

5 In the second stage of the process, a smaller group from among those submitting
6 non-binding proposals were provided the opportunity to conduct additional due diligence
7 and then to make binding proposals for all or predetermined portions of NEP's non-
8 nuclear generating business. A critical component of this second stage of the bidding
9 process was the NEES Companies' specification of certain terms that any bidder
10 submitting a binding proposal must accept. Those terms included the treatment of NEP's
11 NUG purchase commitments. Bidders were advised that an acquirer of NEP's non-
12 nuclear generating assets would be required to assume the economic benefits and burdens
13 of those contracts, but would also receive a specified stream of payments from NEP.

14 Q. Please describe the NEES Companies' reasoning in including this condition in the bidding
15 process.

16 A. The NEES Companies were committed to mitigating the above-market costs of NEP's
17 non-nuclear generating assets, including its NUG purchase commitments. They believed

1 that the bidding process afforded them an opportunity to bring market forces to bear on
2 the mitigation of these costs.

3 By requiring bidders for NEP's generating assets to assume the economic benefits
4 and burdens of those contracts (i.e., to receive from NEP the output of the NUG plants to
5 which NEP was contractually entitled and to pay the amounts due to the NUG suppliers
6 under the contracts), the NEES Companies effectively required each bidder to evaluate the
7 value of those contracts, including the potential for reducing future payment
8 responsibilities, as part of their bidding strategies. Bidders had to factor their evaluations
9 of the NUG purchase commitments into their bids for NEP's non-nuclear generation. A
10 bidder that was willing to reflect in its a bid more optimistic views of market prices and
11 mitigation opportunities could increase its bid and stand a better chance of winning.

12 In this way, the NEES Companies sought to harness market forces, as well as the
13 appetite of the market for NEP's non-nuclear generating assets, as revealed in the first-
14 round proposals, for their effort to mitigate total transition costs, including costs
15 associated with NUG commitments. Bidders were required in effect to capitalize their
16 assumptions about the value of NEP's NUG purchase contracts and the prospects for
17 mitigating those contracts further. The competition to acquire NEP's non-nuclear
18 generating assets gave bidders the incentive to use aggressive assumptions regarding NUG
19 contracts as a means of improving their bids. The benefits flow to consumers through a

1 larger credit to contract termination charges. The successful bidder, not consumers, then
2 bears the risk that its assumptions regarding individual contract mitigation opportunities
3 might prove to be overly optimistic.

4 Q. In your judgment, was this process reasonably designed to maximize the mitigation of
5 transition costs?

6 A. Yes. The NEES Companies acted reasonably in mitigating costs under NUG contracts as
7 part of the bidding process for NEP's non-nuclear generating business. This approach
8 enabled them to take advantage of competitive forces and, in particular, the attractiveness
9 to other companies of NEP's fossil and hydro generating assets, in order to maximize the
10 mitigation that could be achieved for consumers. Standing alone, the NUG purchase
11 commitments are not attractive generating assets. The NEES Companies reasonably
12 concluded that bidders would be more likely to value those assets aggressively if doing so
13 would increase their chances of winning the competition for NEP's other non-nuclear
14 generating assets.

15 Q. What conclusion do you reach regarding Mr. Levitan's claims?

16 A. Mr. Levitan's claim that the NEES Companies failed to mitigate costs attributable to NUG
17 purchase commitments is unfounded. To the contrary, the NEES Companies undertook a

1 carefully considered approach that was reasonably designed to maximize the mitigation of
2 total transition costs, including costs associated with NUG contracts.

3 THE STANDARD OFFER OBLIGATION

4 Q. Mr. Levitan says that the obligation of the winning bidder to serve load under the standard
5 offer obligation depresses the asset value. Do you agree?

6 A. It is impossible to tell, from the bids received, whether the obligation to offer the standard
7 offer depresses the asset value. There is no itemization of any such effect in the bids.
8 More generally, the question of whether providing standard offer service represents a net
9 gain or net loss to the providing company is clearly a matter of judgment involving
10 projections of the numbers and types of customers who will take standard offer service,
11 the market rate for power, the overall demand for energy, the pattern of demand, and
12 other factors.

13 The value of standard offer service to an electricity supplier is also highly
14 dependent on the other commercial value that a potential power seller in the region would
15 place on having the opportunity to serve the load represented by standard offer customers
16 during the initial years of retail competition in Massachusetts. Such a supplier, for
17 example, might want to compare the value of sales under the standard offer to sales it
18 might otherwise try to attract in this new marketplace. Alternatively, sales to standard

1 offer customers might provide a supplier with a more certain level of demand and sales
2 than it could expect otherwise, permitting the firm to cover its fixed costs of power plant
3 ownership or entitlements while covering short-term marginal costs of production as well.
4 In short, Mr. Levitan's premise that the standard offer obligation drives down asset value
5 cannot be proven, either in this specific case or in the general case.

6 Q. But, what if he is correct, that the standard offer obligation has driven down asset value?

7 A. Assuming, arguendo, that the standard offer obligation has depressed the asset value, that
8 is nonetheless an acceptable result given the framework for electricity restructuring in
9 Massachusetts. That framework, set forth both in the legislation and in the Mass. Electric
10 Settlement Agreement approved by the Department, recognizes the importance of the
11 standard offer as a transitional mechanism in helping customers adapt to the restructured
12 electricity environment. Even if the asset value was depressed because of this obligation,
13 that would represent an acceptable trade-off given the important benefits of the standard
14 offer.

15 Q. What are those benefits?

16 A. The standard offer represents an opportunity for customers who are not yet familiar with
17 or ready to participate in the electricity marketplace the opportunity (1) to reap savings

1 from restructuring and (2) to take a reasonable amount of time to decide among the power
2 suppliers choosing to serve the state. Both the Department and the Legislature recognized
3 the importance of these benefits and therefore included the standard offer as a required
4 part of restructuring in the state.

5 Q. Couldn't Mass. Electric conduct a separate auction to acquire a supplier or suppliers to
6 deliver standard offer service?

7 A. Yes. In fact, Mass. Electric will be conducting such an auction. However, it knew --
8 when designing the generating asset auction -- that it would have an overriding obligation
9 to guarantee that the service would be provided at a maximum price to as many customers
10 as might demand the standard offer. Including the standard offer obligation as a condition
11 of the asset purchase represents an insurance policy to ensure that the service will be
12 available at the stated price to those customers who want it. The succeeding auction will
13 ultimately provide an indication of the value of providing standard offer service, as
14 perceived by suppliers in the region.

15 Q. What conclusion do you reach regarding Mr. Levitan's claims about the standard offer
16 obligation.

1 A. First, Mr. Levitan's claim cannot be proven. Second, even if we assume that it is correct,
2 he fails to recognize the overriding public purposes of the restructuring law and regulatory
3 actions taken in Massachusetts that call for the guaranteed provision of standard offer
4 service at a given price to Mass. Electric customers. It was entirely appropriate, given
5 these public purposes, to include the standard offer obligation as a part of the asset
6 transfer.

7 CONCLUSION

8 Q. What is your general conclusion with regard to the aspects of Mr. Levitan's claims about
9 the auction process?

10 A. In his criticisms of the auction process, Mr. Levitan inappropriately attempts to
11 dis-integrate a number of key elements of the plan to restructure electricity service to
12 Mass. Electric's customers. As I have demonstrated, those elements are interrelated, and
13 the decision by the NEES companies to include all of them in its auction process was
14 designed to meet important public policy objectives. When viewed in this manner, the
15 result of the process -- the agreement for the transfer of NEP's non-nuclear generating
16 assets to USGen -- is reasonable and consistent with the public interest. It should be
17 approved by the Department.

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1 Q. Thank you. I have no further questions at this time.